BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992; Rate Regulation	)	MM Docket No. 92-266

COMMENTS OF USA NETWORKS IN RESPONSE TO FIFTH NOTICE OF PROPOSED RULEMAKING

Ian D. Volner
Venable, Baetjer, Howard
& Civiletti
1201 New York Avenue, N.W.
Suite 100
Washington, DC 20005

Of Counsel:

Stephen A. Brenner, Esq.
USA Networks
1230 Avenue of the Americas
New York, NY 10020

June 29, 1994

TABLE OF CONTENTS

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992; Rate Regulation	)	MM Docket No. 92-266

COMMENTS OF USA NETWORKS
IN RESPONSE TO FIFTH NOTICE OF PROPOSED RULEMAKING

With commendable candor, the Commission has re-opened the question whether its rate regulation "going-forward methodology" needs to be substantially changed in order to "better meet our goals of encouraging infrastructure development and the growth of programming." Fifth Notice of Proposed Rulemaking in MM Docket 92-266, ¶ 256 (March 30, 1994). ("Fifth Notice"). USA Networks is uniquely suited to address this question: The operator of the established and popular USA Network, we launched Sci-Fi Channel less than six months before the Commission's rate regulations were put in place; we have hands-on experience with the effects that the Commission's regulatory system has had upon the growth of new services. We know that the existing going-forward methodology simply is not working and that the Fifth Notice raises the wrong question: The issue is not "whether" the methodology "should be modified", id.; the issue is, rather, how the methodology should be changed. We submit these comments to show why the rules must be changed and how the rules, at the minimum, should be constructed.

Summary of Position

The regulation of the cable industry inadvertently has placed a number of barriers in the way of the launch and successful expansion of new cable programming services. While there are many provisions which have created this problem, we have chosen to focus, in these comments, upon the failure of the regulations to provide cable operators with a meaningful incentive to add new services to their regulated tiers and to vigorously promote and market these services. We believe that the cure which we propose will have a significant impact on the growth of new services which will provide the public with more and better entertainment and information services.

Since the issuance of the Commission's Report and Order in April 1993, there has been a virtual "freeze" on the growth of fledgling services and the launch of new services. The well intentioned, but admittedly "cautious," adjustments which the Commission made in its March 30, 1993 Order have not improved the situation. The 7.5 percent "mark-up" plus the declining per channel adjustment factor have not provided cable operators with a real incentive to add new services to regulated tiers.

We urge that the 7.5 percent mark-up be replaced with a fixed fee mark-up of not less than 25 cents. We also urge the Commission to abandon the declining per channel adjustment and establish an adjustment of not less than 5 cents per channel for each new service added to a system.

Unless the Commission acts decisively and promptly, the goal of maintaining diversity and consumer choice in a re-regulated environment will be severely, perhaps irreversibly, frustrated.

The Virtual Freeze on the Expansion of Fledgling and New Cable Programming Services Mandates that the Going-Forward Rules be Changed

The inadequacies of the Commission's going-forward methodology is well illustrated by the impact of the rule on the Sci-Fi Channel. USA Networks' acquisition, planning and development of the Sci-Fi Channel predated the passage of the 1992 Cable Act. The plans, investments and commitments in programming, facilities, transponders and marketing for the new service, running into tens of millions of dollars, were made well before the Commission first issued its benchmark/going-forward rules. Science fiction is a highly popular category for television viewers and movie-goers alike. In order to create a significant niche, the Sci-Fi Channel had to negotiate aggressively for important science fiction product which would have to be aggressively and creatively marketed. USA Networks invested a great deal of money in special programming designed to attract the interests of a broad array of viewers, including programming which emphasizes the scientific component of science fiction. The service itself was launched in an unregulated environment in late September 1992.

The Sci-Fi Channel met with immediate favorable response from both cable operators and the American public.

The Sci-Fi Channel was launched with access to almost 10 million subscribers. The number of subscribers, the favorable response to our innovative programming, and the interest in the new service shown by cable operators which did not add the service at launch led us to be optimistic that our investment was prudent. We had every reason to expect that the service would continue to attract new affiliates and new audiences.

All of that changed on April 1, 1993, when the Commission issued the benchmark/going-forward rules. From that time to this, except for a brief period just before the rules took effect on September 1, 1993, we have experienced no significant growth in subscribers. We are far from being alone in experiencing this Commission-induced "freeze;" BET, the Disney Channel, E! and Encore (among others) state that they also are encountering problems signing up cable systems for carriage of their services in regulated tiers. The trade press continues to report on the daunting difficulties that new cable services and those not yet launched have faced since April 1993. See, e.g., "Operators Give New Networks Little Attention," Muiltichannel News at 3 (March 7, 1994).

Of course, it is not the responsibility of the Congress or this Commission to ensure that the Sci-Fi Channel, or any other service, becomes profitable. In these comments, we are not asking the Commission to completely refrain from rate regulation of systems not subject to effective competition. What we do ask is that the Commission balance its concerns about rate regulation with its desire to promote

greater diversity of speakers and new, innovative services. All we seek is a reasonable opportunity for access to cable subscribers for our new service.

We recognize that the intent of the 7.5 percent mark-up and the per channel adjustment factor contained in the March 30, 1994 Order ("Second Report and Order on Reconsideration") were specifically adopted to "allow cable operators to grow and develop new facilities and services, including new and innovative regulated programming services." Second Report and Order on Reconsideration at ¶236. The reaction in the marketplace has shown that the approach was "cautious" to a fault. Despite the new "incentives," the freeze continues. For the Sci-Fi Channel, the continuation of the freeze is especially frustrating because this service remains one of the, if not the, top choice among cable operators to be added to their service offerings. See, "on Air" Saatchi and Saatchi Advertising, p. 29 (1994) (on file as Exhibit 1 to Comments of Program Providers in MM Docket 92-266 (filed May 16, 1994).

The current going-forward rules have created the freeze upon the launch and growth of new programming services. The problem clearly has been exacerbated by channel capacity limitations, must-carry requirements and retransmission consent. However, the central problem is that the operator plainly gains very little from the addition of a new service to a regulated tier. When one adds the cost of marketing, promoting and even giving notice, the final result is that the

operator loses money. With the "final" rules to take place in a month, there is no sign of a thaw.

Unless the Commission acts immediately and significantly modifies the current rules, the hundreds of millions of dollars that have been invested in new program services may be lost forever to the ultimate detriment of the viewing public. Congress never intended to harm the programming industries. H. Rep. 102-92 at 79, 82. That and the Commission's overriding goal of affording the American public the broadest possible choice of high quality programming, responsive to their interests is, we submit, "complete justification" for a complete overhaul of the going-forward rules. Fifth Notice at ¶256.

The Incentives Afforded Cable Operators to Add New Services to Regulated Tiers Must be Substantially Increased

Both elements of the "incentives" built into the going-forward methodology are inadequate.

First, the 7.5 percent mark-up is simply insufficient for a cable operator to introduce a new service. The inadequacy of the 7.5 percent mark-up is particularly acute -- and inequitable -- in its application to new cable networks that carry a relatively modest program license fees. If a service license fee were $.05 per subscriber per month, at 7.5 percent, it would take the cable operator over seven years just to recover the postage cost incurred in giving the required notice that the new service had been added.

The Commission has suggested that, if cable operators find the risk of launching new services on a regulated tier to be unacceptable, they can always add the service as an a la carte unregulated offering. Second Report and Order on Reconsideration at ¶ 236. This reasoning implicitly assumes that programming designed for carriage as a part of a tier will succeed equally well if carried on an a la carte basis. The assumption is incorrect.

The fact is that cable programming services are not fungible. Some cable networks -- particularly those which carry relatively modest per subscriber fees and are more heavily dependent upon advertising revenues -- simply cannot survive if carried on an a la carte basis. The Sci-Fi Channel was designed, from its inception, to be primarily an advertiser-supported network. As such, its primary source of revenue is directly related to the number of homes that can access its signal.

The second consideration that apparently led the Commission to discount the mark-up was the desire to keep regulated rates "low." Cf. Second Report and Order on Reconsideration at ¶237. This strikes the wrong balance between the competing considerations that underlie the Cable Act of 1992. The Act does not require that rates be "low." It mandates that they be "just and reasonable" or, "not unreasonable." 47 U.S.C. § 543(a), (c). At the same time, Congress insisted that rate regulation not interfere with the paramount goal of "insuring" that cable operators "continue to

expand...their capacity and the programs offered over their cable systems." 47 U.S.C. § 521(b)(3). The continued existence of the freeze upon the launch and growth of new and fledgling services is all the evidence the Commission needs to establish that a "cautious" going-forward methodology yields rates that are not adequate for the purposes of promoting diversity and, therefore, are unreasonably low.

Second, for reasons which are not dissimilar, the per channel adjustment factor methodology is inadequate. In this case, the source of the numbers is clear enough. The Commission has used the so-called "efficiency curve" to calculate what it perceives to be the additional cost that a cable operator incurs when it activates an additional channel. Because of the existence of the curve, systems with more than 36 activated channels may increase their per channel/per subscriber charge per month by only 2 cents, and systems with 50 or more channels receive only 1 cent.

The Commission's search for "complete justification" in terms of the actual cost associated with the activation of an additional channel is misguided. There is nothing in the Act, or its legislative history, that requires the Commission to adhere slavishly to cost-of-service considerations in the development of its rate regulations. On the contrary, the whole notion of the benchmark/going-forward methodology is to avoid the economic inefficiencies, competitive distortions and administrative costs associated with the attempt to precisely measure costs. The Commission's approach to the per channel

adjustment ignores the intangible benefits that subscribers receive when a cable operator activates an additional channel and adds a new service to it. It also assumes, falsely, that consumer response to increased rates associated with additional services is perfectly inelastic. It produces results that are perverse: The more channels the cable operator adds, the more value subscribers receive, but the smaller the adjustment the cable operators is permitted to take. It reaches the point -- at or above 26 channels -- where, even if the one-to-three-cent adjustment fully recovers cost over time, it is simply not worth the cable operator's time and effort to add a new service.

The "complete justification" for a modification of the per channel adjustment factor does not lie in considerations of cost. It lies in the need to appropriately balance rate regulation with the preservation and enhancement of programming that the American public wants and is willing to pay for. This requires that the Commission exercise its judgment, as well as its computational skills, in setting a reasonable per channel adjustment factor.

In sum, both elements of the "incentives" intended to be created by the March 30, 1994 Order are inadequate. Both must be changed.

The Mark-Up Should be a Fixed Fee of Not Less Than 25 Cents. The Minimum Channel Adjustment Factor Should Be Not Less Than 5 Cents

USA Networks' "solution" to the deficiencies of the existing going-forward methodology, is (i) to establish a mark-up (in addition to the program license fee) on a fixed-fee

basis at not less than 25 cents, and (ii) to increase the per channel adjustment factor to not less than 5 cents per channel for each new service added to a system.

There are several virtues to setting a fixed-fee mark-up. Most importantly, it eliminates the invidious discrimination that arises under the existing methodology between cable programming services with relatively "high" per subscriber fees and those with "low" (or no) per subscriber charges. A fixed-fee mark-up levels the playing field in the fiercely competitive cable programming network market. Because the mark-up is added to the actual program licenses cost in determining the going-forward rate, it enables the cable operator to base its editorial decision relating to new services on the consideration that should matter -- whether the service is likely to be responsive to the interests and concerns of the operator's subscribers.

Neither we nor the Commission can be sure that 25 cents is an appropriate reflection, on average, of the mark-up necessary to provide cable operators with the incentive to add new services to their regulated tiers. Certainly, it is not too high. As others have pointed out, the 25 cent per channel charge is significantly less than the price paid by a subscriber in other multichannel distribution markets which are both competitors to cable and highly competitive. See Comments of Program Providers at page 8 (filed May 16, 1994). In terms of the value that cable subscribers receive when a new service is added to a regulated tier, 25 cents per month is neither

unjust nor unreasonable. The Commission will have to monitor developments to assure that an increase of the mark-up to 25 cents plus the cost of the service does open the way for the launch and growth of new services.

The concept of fixing a minimum per channel adjustment charge, beyond which the adjustment does not decline, is equally rational. According to the Commission's calculations, 5 cents represents the cost to a 26-channel cable system to activate one additional channel. Twenty-six channels represents the mean of system channel capacity on which the curve was calculated, and it is at least an approximation of the median in terms of channel capacity among cable systems throughout the United States. It is precisely the sort of pragmatic adjustment to cost-of-service considerations that must be made if the conflicting public policies underlying the Cable Act are to be reconciled.

Conclusion

The Commission must not delay coming to grips with the plain and undeniable reality that the adjustments it made to the going-forward methodology in its March 30, 1994 Order, although well intended, are inadequate. The legislative mandate of rate regulation for systems not subject to effective competition must be balanced against the objective of promoting diversity. This requires that the Commission broaden its focus beyond considerations of cost and price. The Commission must recognize that cable operators simply will not add new services to regulated tiers without a fair financial return.

We cannot say, with certainly, that the approach to the going forward methodology that we have endorsed in these comments will eliminate the freeze on the launch and growth of new services. We can say, with absolute confidence, that the approach outlined here is far preferable to the existing methodology.

Respectfully submitted,

Ian D. Volner
Venable, Baetjer, Howard
& Civiletti
1201 New York Ave., N.W.
Suite 1000
Washington, D.C. 20005

Of Counsel:

Stephen A. Brenner, Esq.
USA Networks
1230 Avenue of the Americas
New York, NY 10020

June 29, 1994

IDV:kmr-24072/107129-2874/DCGVC